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ICPS downgrades economic development forecast for 2003–2004

In the new issue of the* Quarterly Predictions *journal, to be published next week, ICPS has worsened its economic development forecast for Ukraine in 2003–2004. According to the updated forecast, in 2003 Ukraine's GDP will increase by 3.5%, while in 2004 growth will reach 4%. The main factor in reconsidering the forecast was the poor economic policy for the next two years. Moreover, the escalating political battle (preparatory to the presidential elections in the fall of 2004) will increase investment risk and dampen consumer confidence. On the other hand, Ukraine's GDP growth will remain in the black, thanks to entrepreneurial initiative and competition. The current account balance will also remain positive, which will allow the preservation of a stable hryvnia exchange rate

2002 summary

The Q3'02 results show a continued slow-down in the growth of the Ukrainian economy. According to our calculations, in Q3'02, Ukraine's GDP increased by 3.6% over Q3'01. Compared to last year, investment growth rates have fallen in 2002. This reduction has taken place despite the high liquidity of the banking system and the reduction of loan interest rates. In contrast to the record economic growth in 2001, foreign direct investment (FDI) inflow in 2002 may turn out to be the smallest in the past three years.

We believe that this situation is the result of the absence of positive changes in Ukraine's business climate during the past year. In particular, procrastination has occurred with regard to the approval of the following long-awaited decisions affecting investors: (1) reduction of tax pressure; (2) introduction of the new Civil Code; (3) reforms in the social security system, to guarantee targeted assistance and ensure enforcement of contracts; and (4) consideration of cost of capital in the tariffs of infrastructure sectors. Moreover, the worsened business climate was exacerbated by repeated instances of Ukraine's "enforcement authorities" being used to create pressure on businesses in the course of political conflicts, as well as non-transparent decisions being approved by the government that limited competition (in January–October 2002, the government approved 89 decisions with "not to be published" status, which amounted to 4.3% of all approved decisions[1]).

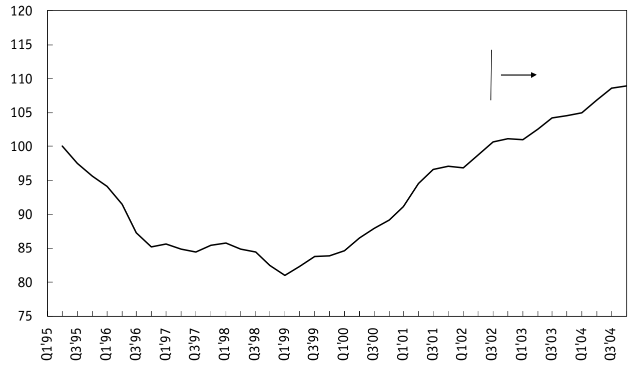
Forecast for 2003–2004

We have downgraded our forecast for 2003–2004, predicting a GDP growth in 2003 of 3.5%, and in 2004 of 4%. The worsened forecast is the result of the reconsideration of our assumptions regarding the evolution of government policy in Ukraine and of the GDP dynamics of Ukraine's trading partners.

[1] In 2001 the percentage of such decisions was 3.1% of the total, while in 2000 it was 3.7%.

Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee; calculations and forecast by Quarterly Predictions.

Our reconsideration of assumptions regarding state policy were governed by the following factors:

- The current political battle, with the stakes being victory in the 2004 presidential elections;
- The differences on political issues between the forces in power and the opposition prevail over their mutual interests with regard to key economic reforms; this will interfere in reaching any productive consensus for the next two years;
- The threat of forced redistribution of property in course of political struggles triggered by the fact that big business and politics are juxtaposed. Forced redistribution of property means that investors lose all their investments;
- Reduced trust of Ukrainian citizens in the government[2];

Under these conditions, state policy will not be focusing on any long-term vision of national development. Instead, the state policy sphere will be dominated by short-term political interests. Preservation of the old procedures for government operations will exacerbate this situation even more. In the absence of an integrated development vision, the system of coordinating decisions through high-level endorsement as opposed to horizontal communications and debate will lead to important decisions being held back. At the same time, other decisions (on privileges or individual conditions for activity, for example) will be pushed through, under pressure for businesses resorting to such tactics because of political uncertainty.

[2] According to a survey conducted by the Razumkov Ukrainian Centre for Economic and Political Research, 53.3% of respondents do not support the actions of the President of Ukraine, while 45.1% of respondents do not support the actions of the Verkhovna Rada (see *Dzerkalo tyzhnia*, No. 37, 28 September 2002).

The combination of intense political battles and ineffective state policy will bring the following negative results for the economic dynamic:

• Increased risk for domestic investments. The threat of redistribution of property in consequence of political conflicts and, correspondingly, the lack of long-term corporate strategies, will lead to reduced volumes of investment, particularly long-term ones, into business development;

• Outflow of capital from Ukraine, and an insignificant volume of foreign direct investments. We anticipate that FDI inflow in Ukraine during the forecast period will not exceed $500 million per year. In our view, Ukraine will lose out to Russia with regard to competition for FDI; Russia has maintained political stability and has high growth rates;

• Worsened expectations and consumer confidence, along with reduced income growth and consumption on the part of the population. Deteriorating business expectations will lead to reduced demand for workers and a reluctance on the part of job providers to increase salaries.

At the same time, we believe that the worsening political situation will have varied effects on different sectors of the economy. The greatest risk will be concentrated in the infrastructure sectors, where state ownership prevails and significant cashflows are concentrated. Losses will be sustained by sectors producing investment goods and services, especially construction. To a lesser extent, the political uncertainty will affect sectors where there is a lot of competition, including trade and transportation. However, these sectors will suffer indirectly, due to the reduction of the internal consumption dynamic.

We anticipate increases in Ukrainian consumer prices in 2003–2004, with inflation reaching 6% at the end of 2003 and 5.5% at the end of 2004. Factors affecting the price increases include (1) moderate tariff increases for electricity and public utilities; and (2) price pressure from producers.

The recovery in GDP growth for Ukraine in 2004, in our opinion, will be due to the following possible factors:

• Rapid growth in the economies of Ukraine’s foreign trade partners;

• Reduced effective rates of individual income tax, as a result of adoption of the Law of Ukraine “On individual income tax”;

• Increased budget spending on the eve of the presidential elections.

Meanwhile, the possibility exists of an even more pessimistic scenario, if the following risks transpire:

• International isolation of Ukraine if instances of violation of UN sanctions on the part of Ukraine are revealed;

• Constant blocking of the work of the parliament due to the conflict between the forces in power and the opposition; and

• Escalation of mass protest actions.

Our forecast will be overly pessimistic if the Verkhovna Rada, President of Ukraine, and executive government will return to working on strategic issues concerning Ukraine’s economic policy. In this case, the growth rates of the Ukrainian economy will be higher than in our forecast. In our view, Ukraine has strong entrepreneurial initiative; thus, only a few key decisions need to be approved in order for the Ukrainian economy to continue its growth at 2000-2001 rates.■

If you wish to receive the Quarterly Predictions journal, please contact Yevhenia Yehorova, ICPS publications coordinator, at tel.: (38-044) 236-5464, e-mail: marketing@icps.kiev.ua, or fill in the subscription form at the web-site: www.icps.kiev.ua/ukr/subscription.html

Major indicators

	2001 (estimate)	2002	2003 (forecast)	2004
Economic activity				
GDP, *billions UAH*	201.3	213.1	232.7	254.1
Real GDP, *apc**	9.1	4.3	3.5	4.0
Real industrial output, *apc*	14.2	6.0	5.0	5.5
Real agricultural output, *apc*	10.0	3.0	2.6	3.2
Gross investment, % of GDP	20.2	20.1	20.6	20.8
FDI, *millions USD* (1)	769	500	500	400
Real household disposable income, *apc*	14.5	20.0	7.0	8.0
Real retail trade, *apc*	11.7	12.0	70	7.0
Prices				
Consumer price index, *apc*	6.1	-0.2	6.0	5.5
Producer price index, *apc*	0.9	4.5	5.0	6.0
Labour market				
Population, *millions*	49.0	48.1	47.6	47.1
Real wages, *average apc*	20.9	18.0	6.0	7.0
Unemployment rate, % (ILO methodology)	11.0	10.5	10.5	11.0
Foreign economic activity				
Exports of goods&services, *apc*	8.0	6.0	4.0	7.0
Imports of goods&services, *apc*	14.1	4.5	6.5	8.5
Current account balance, *% GDP*	3.7	5.1	3.5	2.5
Budget				
Revenues (consolidated), *% GDP* (2)	25.2	28.0	27.0	26.5
Balance (IMF methodology), *% GDP*	-1.8	0.6	0.2	-0.2
Financial indicators				
Monetary base, *apc*	37	38	27	27
M3, *apc*	42	38	28	29
NBU international reserves, *millions USD*	3095	4585	5470	5730
Official exchange rate (average annual), *UAH/USD*	5.37	5.33	5.46	5.64
Loan interest (average annual), *yearly %* (3)	32	24	18	15
International				
World GDP, *apc*	2.5	2.7	3.7	3.9
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	2.7	3.2	3.7	4.1

** apc = annual percentage change*
*** aapc = average annual percentage change*

Notes:

(1) according to NBU;
(2) calculated by IMF methodology since 2001;
(3) commercial banks loans, UAH

Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.

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ICPS Newsletter editor Yevhen Shulha (shulha@icps.kiev.ua)
Phone: (380-44) 236-4477
English text editor D. (Ksenia) Ovcharenko.